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RIGHTS IN COLLATERAL UNDER U.C.C. § 9-203

Article 9 of the Uniform Commercial Code deals with transactions whereby one party (a debtor) grants a security interest to another party (a secured party) in a piece of property. The security interest is normally transferred by the debtor to the secured party to secure payment on an obligation owed by the debtor to the secured party. U.C.C. section 9-203 provides three general requirements that must be met for a security interest to attach. One of those requirements is that the debtor must have “rights in the property” in which he conveys a security interest.¹

The focus of this comment will be to determine the rights which one might have in a piece of property that are sufficient to support a security interest in that piece of property. Pursuant to section 9-203 of the Uniform Commercial Code, “a security interest is not enforceable against the debtor or third parties with respect to collateral and does not attach unless: (a) the collateral is in possession of the secured party pursuant to an agreement, or the debtor has signed a security agreement which contains a description of the collateral . . . ; (b) value has been given; and (c) the debtor has rights in the collateral.”²

Under section 9-203(2) of the Uniform Commercial Code a security interest becomes enforceable against the debtor when requirements a, b, and c above have all been met.³ Thus, determining whether a debtor has “rights in collateral” will inevitably be a crucial question in determining whether a secured party will have the right to look to specific assets of the debtor for payment of the subject debt upon default by the debtor.⁴

1. See generally U.C.C. § 9-203(1) (1989). Throughout this comment the following identification system will be used:

- (a) Debtor—will refer to the party who is conveying the security interest.
- (b) Secured Party—will refer to the party who is obtaining the security interest.
- (c) Seller—will refer to the person selling collateral to the debtor.

2. U.C.C. § 9-203(1) (1989).

3. U.C.C. § 9-203(2) (1989). “A security interest attaches when it becomes enforceable against the debtor with respect to the collateral. Attachment occurs as soon as all the events referred to in subsection 1 [signed security agreement, secured party has given value, debtor has rights in the collateral] have taken place unless specific agreement postpones attachment.” *Id.*

4. U.C.C. § 9-501(1) provides that when a debtor is in default under a security agreement a secured party may enforce his security interest to satisfy the debt. That is, he may take possession of the collateral (U.C.C. § 9-503), sell the collateral (U.C.C. § 9-504(1)) and use the proceeds of such sale to satisfy the debt (U.C.C. § 9-504(1)(a)). U.C.C. §§ 9-501(1), -503, -504(1) (1989).

It has been noted that the "'rights in collateral' language merely state[s] a truism, namely, that the debtor normally can only convey something once he has something" Some interests are unquestionably sufficient to support a security agreement; that is, if a debtor has full legal title to a piece of property it can hardly be argued that the debtor's rights are not sufficient to support a security interest.⁶ Conversely, mere possession of property in which the debtor has no ownership rights does not afford the debtor the right to convey a security interest in that property.⁷ In fact, since the adoption of Article 9, courts have used this requirement to invalidate security interests held by secured parties. Thus, it is important to be aware of the types of interests that a debtor might have in collateral and whether those interests will be deemed sufficient to support a security interest.

This comment will focus on four common types of property interests and will discuss whether those interests are sufficient to support a security interest. The interests examined will be: (1) a debtor's contractual interest in property; (2) a debtor's interest as a bailor of property; (3) a debtor's interest in corporate owned property; and (4) a debtor's interest in property which he owns jointly with another person.

I. DEBTORS' PROPERTY INTERESTS

A. Debtor's Contractual Interest in Acquiring Property

1. Background

Many times debtors convey a security interest in property which they do not yet own. Uniform Commercial Code section 9-204(1) provides that

5. J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE 988 (1988) (hereinafter WHITE, UCC). See also R. HILLMAN, J. McDONNELL & S. NICKLES, COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE § 18-2 (1985) (hereinafter HILLMAN, UCC). "The qualifying language 'to the extent' is justified by a fundamental principle of common law and common sense, which is that one cannot convey rights greater than one's own. . . . The 9-203(1)(c) requirement that the debtor have 'rights in the collateral' is simply an embodiment of the common-law precept that one cannot convey what one does not have. A corollary rule also obtains under article 9, although not as clearly and with many exceptions. The rule is that one cannot convey rights greater than one's own." *Id.*

6. See HILLMAN, UCC, *supra* note 5, § 18-3 (1985). See generally WHITE, UCC, *supra* note 5, at 987.

7. See HILLMAN, UCC, *supra* note 5, § 18-2 n.6 (1985) (citing *Cain v. Country Club Delicatessen of Saybrook, Inc.*, 25 Conn. Supp. 327, 203 A.2d 441 (1964)), *Disch v. Raven Transfer & Storage Co.*, 17 Wash. App. 73, 561 P.2d 1097 (1977). See also WHITE, UCC, *supra* note 5. "If the goods are entirely owned by a third party, mere acquisition of possession by the debtor will not be enough." *Id.* at 987 (citing *Disch v. Raven Transfer & Storage Co.*, 17 Wash. App. 73, 561

"a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral."⁸ For instance, a secured party might have an agreement with a debtor which grants the secured party a security interest in "all equipment of the debtor now owned or hereafter acquired."⁹ The security interest, in such a situation, would attach to any item of equipment owned by the debtor at the time the security interest was created or acquired by the debtor after the time of the creation of the security interest.¹⁰

In analyzing the point at which a security interest attaches to after-acquired property, one must look at each of the requirements of U.C.C. section 9-203(1). That is, in order for a security interest to attach (be enforceable against a debtor)¹¹ the three elements of U.C.C. section 9-203(1) must be met: there must be a security agreement containing the debtor's signature,¹² the secured party must have given value,¹³ and *the debtor must have rights in the collateral*.¹⁴

Close analysis will show that a secured party's security interest in after-acquired property will attach to such property when the debtor obtains rights in the property. The other two requirements of U.C.C. section 9-203(1) have already been met,¹⁵ therefore, at the time the debtor acquires rights in property, the secured party's security interest will attach immediately to that property. But determining when a debtor "obtains rights in collateral" can be complicated. It is a relatively simple case when a debtor orders, pays for, and receives delivery of property in a single

8. U.C.C. § 9-204(1) (1989).

9. U.C.C. § 9-109(2) (1989) defines equipment as goods that "are used or bought for use primarily in business (including farming or a profession) or by a debtor who is a nonprofit organization or a governmental subdivision or agency or if the goods are not included in the definitions of inventory, farm products or consumer goods."

10. See U.C.C. §§ 9-203(1), 9-203(2), 9-204(1) (1989).

11. U.C.C. § 9-203(2) (1989).

12. U.C.C. § 9-203(1)(a) (1989).

13. U.C.C. § 9-203(1)(b) (1989).

14. U.C.C. § 9-203(1)(c) (1989).

15. The original security agreement containing the after acquired property clause will presumably be signed and probably contains a sufficient description of the after acquired property. U.C.C. § 9-203(1)(a) (1989). U.C.C. § 9-203(1)(b) (1989) requires that a secured party give value in order to obtain a security interest in property of a debtor. In exchange for the security interest the secured party will have given value in the form of a loan to the debtor. The loan will satisfy the requirement that the secured party give value to obtain a security interest in property later acquired by the debtor. U.C.C. § 1-201(44) (1989) states: "Except as otherwise provided with respect to negotiable instruments and bank collections (sections 3-303, 4-208 and 4-209) a person gives value for rights if he acquires them . . .

....

(b) as security for or in total or partial satisfaction of a preexisting claim." Thus, § 9-203(1)(b) will have been satisfied.

transaction. The analysis becomes much more complex if the debtor first enters into a contract to purchase property from a seller but receives delivery and pays for the property at a later time. The rest of this subsection will discuss the secured party's rights in an asset vis-à-vis the debtor-purchaser and the seller at different times in the process of contracting to purchase the asset, receiving delivery of the asset, and then paying for the asset.

2. Secured Party v. Seller's Right to Reclaim

The easiest way to explore the rights of each party will be through examination of hypothetical situations. Assume that a secured party has a security interest in all of debtor's trucks now owned or hereafter acquired.¹⁶ Assume further that this security interest is granted by the debtor to the secured party in a writing signed by the debtor on January 1, 1989. In a contemporaneous agreement the secured party loans the debtor one million dollars. The requirements of U.C.C. section 9-203(1)(a) (written security agreement signed by the debtor) and section 9-203(1)(b) (secured party must give value) have been met. Thus, a security interest will immediately attach in favor of the secured party in any trucks which the debtor has "rights in" at the time the security agreement is executed and the loan is made.

Now assume that on January 15, 1989, the buyer enters into a contract with ABC Company to purchase a truck. On January 17, 1989, ABC Company sends buyer the truck in exchange for buyer's promise to pay \$15,000 on February 15, 1989. The secured party's interest in the new truck will certainly attach at the time the debtor receives delivery.¹⁷ What

16. See *supra* note 8 and accompanying text for a discussion of after acquired property clause.

17. The seller might be tempted to alter this result by including a clause that no title shall pass to the buyer until the seller has been paid. U.C.C. § 2-401 (1989) provides that "any retention or reservation by the seller of the title (property) in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest." That is, if the seller does not take a security interest in the property sold or attempts to prevent title from passing to the buyer until after the goods have been paid for, the buyer will have unencumbered ownership rights to the collateral. Even if the secured party did retain a security interest in the collateral, the debtor would still have rights in the collateral and could further encumber it. See HILLMAN, UCC, *supra* note 5, § 18-2 (1985).

The priority conflict between the seller of the property and the secured party would be resolved by referring to U.C.C. § 9-312(4) (1989) which provides "a purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter." So, if the seller files a financing statement in the appropriate office (U.C.C. § 9-302 (1989)) before, or within ten days after, the debtor receives delivery of the collateral his claim for the purchase price will be senior to the secured party's claim. Nevertheless, the secured party will have a security interest in the collateral.

if the seller learns on January 31, 1989, that the buyer is insolvent? Section 2-702 of the U.C.C. provides that

Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply.¹⁸

Thus, it would appear that the seller could reclaim the truck from the buyer under U.C.C. section 2-702(2) and effectively extinguish the secured party's security interest. But U.C.C. section 2-702(3) probably alters this result. That section states that "the seller's right to reclaim under [2-702(2)] is subject to the rights of a buyer in the ordinary course or other *good faith purchaser* under this Article (section 2-403)"¹⁹ Clearly the secured party is not a buyer in the ordinary course,²⁰ but he apparently is a good faith purchaser.²¹ Therefore the seller's right of reclamation would be subordinate to the security interest of the secured party.

For instance, in *In re Bensar*,²² BancOhio National Bank (BNB) had a security interest in all inventory of Bensar Company, Inc. (Bensar) now owned or hereafter acquired.²³ United States Billiards Company, Inc. (U.S.B.) sent pool tables to Bensar.²⁴ These pool tables constituted inventory in Bensar's hands so the security interest of BNB attached to the pool tables.²⁵ U.S.B. learned that Bensar was insolvent on June 13, 1983.²⁶ U.S.B. had not yet received payment for the pool tables. An officer of USB called a Bensar employee on June 16, 1983 and demanded reclamation.²⁷ Thus, the critical question was whose right in the pool tables was senior: BNB's security interest or U.S.B.'s right of reclamation. The court held that since BNB's "after acquired interest in the debtor's [Bensar's] inventory was

18. U.C.C. § 2-702(2) (1989).

19. U.C.C. § 2-702(3) (1989) (emphasis added).

20. U.C.C. § 1-201(9) (1989) defines buyer in the ordinary course as "a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind" See *In re Sitkin Smelting & Refining, Inc.*, 639 F.2d 1213 (5th Cir.), *reh'g denied*, 645 F.2d 72 (5th Cir. 1981) (secured creditor is not a buyer in the ordinary course within the meaning of the Uniform Commercial Code).

21. *In re Bensar Co.*, 36 Bankr. 699, 703 (Bankr. S.D. Ohio 1984) ("secured creditors who act in good faith qualify as good faith purchasers"). U.C.C. § 1-201(19) (1989) defines "good faith" as meaning "honesty in fact in the conduct or transaction concerned."

22. 36 Bankr. 699 (Bankr. S.D. Ohio 1984).

23. *Id.* at 700.

24. *Id.*

25. *Id.* at 699.

26. *Id.*

27. *Id.* at 701.

created through a voluntary transaction, and since the bank has acted in good faith, its rights as a good faith purchaser are superior to those of U.S.B. as a reclaiming seller under U.C.C. section 2-702(3)."²⁸ The result reached by the court in *In re Bensar* is in accord with the results reached by other courts addressing this issue.²⁹

Should courts addressing this question come to this result? As recognized by White and Summers, "equities between competing claimants may be fought out in the name of this phrase ('rights in the collateral')."³⁰ It is true that a textual consideration of U.C.C. section 2-702(2) and U.C.C. section 2-702(3) will result in a finding in favor of the secured party. The policy of favoring a good faith purchaser over a reclaiming seller is to promote commerce. That is, customers would probably be reluctant to purchase a pool table from Bensar if they believed that a seller could subsequently take the pool table away from them if Bensar became insolvent or defaulted on his obligation to pay the seller. Similarly, a creditor would be much less likely to loan money collateralized by the pool tables currently held by Bensar if they believed this security interest would be subordinate to an unpaid seller's right to reclaim.³¹ In order to promote commerce the rights of secured parties acting in good faith and buyers in the ordinary course are elevated above the rights of sellers asserting a right of reclamation.

A strong argument can be made, however, that these policy considerations are not applicable when the contest is between the right of a seller to reclaim and the right of a secured party in *after acquired collateral*. For instance, in *In re Bensar*, BNB probably did not change its position in reliance (i.e., loan money to Bensar) on the pool tables that would later be sent to Bensar by U.S.B. The result in *In re Bensar* would be even more tenuous if the secured party's security interest was in an asset that does not turn over in the ordinary course of business. Clearly, in the case of an after acquired security interest in a non-revolving asset, a secured party will not have changed positions in reliance on a debtor's later acquisition of the collateral.³² Therefore, a secured party who obtains an

28. *Id.* at 703.

29. See e.g., *In re Samuels & Co.*, 526 F.2d 1238 (5th Cir. 1976).

30. WHITE, UCC, *supra* note 5, at 990.

31. Under U.C.C. § 2-702(3) (1989), "the seller's right to reclaim under subsection (2) is subject to the rights of a buyer in the ordinary course or other good faith purchaser under this Article"

If Bensar defaulted on its obligation to the seller it would have voidable title to the pool tables. Under U.C.C. § 2-403(1) (1989), "[a] person with voidable title has power to transfer a good title to a good faith purchaser for value."

32. In fact, because of the effects of U.C.C. § 9-312(3) and U.C.C. § 9-312(4) most sophisticated secured parties will not loan money in reliance on later acquisitions of inventory by the debtor to secure the loan. If the seller of the inventory takes proper steps his security interest will be senior to that of the secured

interest in an asset of a debtor through the operation of an after-acquired property clause does not have the same need for protection from a seller's right of reclamation as does a purchaser of the asset or a secured party who loans money collateralized originally by the asset.

3. Secured Party v. Seller—Goods Identified to the Contract but not Delivered

The prior cases and examples have revolved around the secured party's rights vis-à-vis the seller after the debtor has taken delivery of the property. Now suppose that the secured party obtains a security interest in all of debtor's trucks now owned or hereafter acquired. Assume that the debtor contracts to purchase a truck from the seller. What are the rights of the secured party vis-à-vis the seller after the debtor contracts to purchase the truck from the seller but before delivery occurs?

U.C.C. section 2-501 provides that "[t]he buyer [debtor] obtains a special property and an insurable interest in goods by identification of existing goods as goods to which [a] contract refers"³³ "These non-title interests may in themselves be sufficient rights in collateral to support a security interest in the goods" in the secured party's favor.³⁴ In the example set forth in the previous paragraph the debtor will have rights in the truck sufficient to support a security interest in favor of the secured party. Is there any value in having a security interest in the truck founded only on the debtor's insurable or special property interest in that truck?

party. U.C.C. § 9-312(3) (1989) provides that:

A perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and also has priority in identifiable cash proceeds received on or before delivery of the inventory to a buyer if

- (a) the purchase money security interest is perfected at the time the debtor receives possession of the inventory; and
- (b) . . . [holder of conflicting security interests are sent notice of seller's intention to sell debtor inventory];
- (c) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and
- (d) the notification states that the person giving the notice has or expects to acquire a purchase money security interest in inventory of the debtor, describing such inventory by item or type.

33. U.C.C. § 2-501(1) (1989). Section 2-501(1) goes on to provide that: "In the absence of explicit agreement identification occurs

. . . .

(b) if the contract is for the sale of . . . goods . . . when [the] goods are shipped, marked or otherwise designated by the seller as goods to which the contract refers"

34. HILLMAN, UCC, *supra* note 5, § 18-14 (citing *In re Pelletier*, 5 U.C.C. Rep. Serv. (Callaghan) 327 (Bankr. D. Me., 1968)).

"Clearly the answer is yes if the [truck] suffers some casualty that is covered by insurance payable to the secured party or the debtor."³⁵ Under U.C.C. sections 9-306(1) and (2) the amount received from the insurance company would be proceeds and thus the secured party would be entitled to look to the insurance money to satisfy the debt.³⁶

What if the truck is not lost or destroyed in an event covered by insurance but instead the debtor breaches the contract to purchase the truck? Will the secured party have a security interest in the truck senior to the rights of the seller? "The secured party will rely on the [residual] rule of Section 9-201 that a security agreement is effective against the debtor and *third parties* (including the seller) 'except as otherwise provided by this act.'"³⁷ The secured party will argue that Article 9 does not "otherwise provide" that a secured party's security interest is subordinate to a title holder's interest. But this argument overlooks the obvious; "[n]othing in Article 9 supports this assumption that once a security interest attaches, it exists independently of the debtor's rights on which it is based"³⁸ Thus, when the debtor breaches the contract for purchase of the truck he loses all interest in the truck.

The rights of the secured party may be greatly enhanced if the seller, rather than the buyer, breaches. Assume for instance that the value of the truck is \$40,000 at the time the contract is made and increases to \$50,000 prior to delivery. The seller decides not to follow through with the contract because he can sell the truck for more elsewhere. There are certain situations in which the debtor would be entitled to force the seller to follow through with the contract.³⁹ If the debtor chooses to do this he will ultimately have full possession and title to the truck and the secured party's security interest will clearly attach to the truck via the after-acquired property clause.

35. HILLMAN, UCC, *supra* note 5, § 18-5 (1985).

36. U.C.C. § 9-306(1) (1989) provides that proceeds include: [W]hatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds. Insurance payable by reason of loss or damage to the collateral is proceeds, except to the extent that it is payable to a person other than a party to the security agreement. Money, checks, deposit accounts, and the like are 'cash proceeds' all other proceeds are non cash proceeds.

U.C.C. § 9-306(2) (1989) provides in pertinent part that "a security interest . . . continues in any identifiable proceeds . . . received by the debtor."

37. HILLMAN, UCC, *supra* note 5, § 18-5 (1985) (citing U.C.C. § 9-201 (1985)) (emphasis added).

38. HILLMAN, UCC, *supra* note 5, § 18-5 (1985).

39. U.C.C. § 2-716(1) (1989) states that "specific performance may be decreed where the goods are unique or in other proper circumstances."

U.C.C. § 2-716(3) (1989) states that "[t]he buyer has a right of replevin for goods identified to the contract if after reasonable effort he is unable to effect cover for such goods or the circumstances reasonably indicate that such effort will be unavailing."

The debtor may decide, however, to sue for damages rather than replevin or specific performance. He or she would be entitled to recover the excess of the fair market value of the truck over the contract price—\$10,000 in this case.⁴⁰ Would the secured party's security interest attach to the \$10,000 recovered by the debtor as damages? The case law on this point is scant. It would appear, though, that the best result would be to allow the secured party's security interest in the truck to attach by operation of U.C.C. section 9-306(2) to the damage award recovered by the debtor. This result is sound for two related reasons. First, the debtor has, in a sense, recovered the \$10,000 judgment upon disposition of the collateral. Section 9-306(1) defines proceeds to include "whatever is received upon the sale, exchange, collection or *other disposition of collateral*"⁴¹ As discussed above, the secured party's security interest will "continue in any identifiable proceeds."⁴² Thus, a fair reading of the statute would lead one to conclude that the secured party's security interest, in the above hypothetical, should continue in the \$10,000 recovered by the debtor from the seller.⁴³

The second reason for allowing the secured party's security interest to continue in the \$10,000 is that this would closely approximate the positions of the parties if the sale had in fact occurred.⁴⁴ The positions of each of the parties had the sale been made would be as follows: (1) the *secured party*, as shown above, would have had a security interest in the truck. Assuming the debtor borrowed the money to pay the \$40,000 and further assuming that the truck had a \$50,000 fair market value, the value of secured party's security interest would be \$10,000. This is true because whether the debtor borrowed the \$40,000 from the seller or from a third party lender, the secured party's security interest would be subordinate to the seller's or third party lender's security interest because of the purchase money security interest rules of sections 9-312(3), (4);⁴⁵ and (2) had the

40. See generally D. DOBBS, REMEDIES—DAMAGES, EQUITY, RESTITUTION 785 (1973).

41. U.C.C. § 9-306(1) (1989) (emphasis added).

42. U.C.C. § 9-306(2) (1989).

43. The case seems particularly clear when the debtor in fact has an Article 2 right to obtain the specific goods. If, in our hypothetical, the debtor has a right to obtain the truck but instead seeks to recover a damage amount, his rights in the truck are gone forever. This is true because the debtor has elected his remedy. See generally D. DOBBS, *supra* note 40, § 1.5. Thus, in exchange for his rights in the truck the debtor has received \$10,000. As mentioned before, the \$10,000 is proceeds under § 9-306(1) and the secured party's security interest continues in the \$10,000 under § 9-306(2).

44. D. DOBBS, *supra* note 40, 786. "The traditional goal in awarding damages for breach of contract is to award a sum that will put the non-breaching party in as good a position as he would have been in had the contract been performed." *Id.*

45. U.C.C. § 9-312(4) (1989). See also U.C.C. § 9-107 (1989), which states that:

contract been carried out, *the debtor* would have had a \$50,000 truck subject to a \$40,000 lien in favor of a purchase money lender. He would have had \$10,000 in value of the truck over and above the purchase money lien. The \$10,000 would have clearly been subject to the lien of the secured party. Thus, in order to place the debtor in the same position he would have been in had the contract been carried out, the secured party's lien should be allowed to attach to the \$10,000 damage recovery.⁴⁶

B. Debtor's Interest as Bailee of Property Belonging to Another

1. Background

There are a number of different definitions of bailment.⁴⁷ "A bailment may be defined as a contract by which the possession of personal property

[A] security interest is a 'purchase money security interest' to the extent that it is

(a) taken or retained by the seller of the collateral to secure all or part of its price; or

(b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

46. There is one other important implication in determining whether contractual rights in collateral are sufficient to support a security interest. U.C.C. § 9-103(1)(b) (1989) states:

[E]xcept as otherwise provided in this subsection, perfection and the effect of perfection or non-perfection of a security interest in collateral are governed by the law of the jurisdiction where the collateral is when the last event occurs on which is based the assertion that the security interest is perfected or unperfected.

The case of *Joint Holdings & Trading Co. v. First Union Nat'l Bank of North Carolina*, 50 Cal. App. 3d 159, 123 Cal. Rptr. 519 (1975), illustrates the application of 9-103. Apparently in March 1972 and September of 1973, Brennan Corporation (hereinafter Brennan) granted First Union National Bank of North Carolina (hereinafter Bank) a security interest in all of its inventory now owned or hereinafter acquired. *Id.* at 160, 123 Cal. Rptr. at 522. Bank properly filed financing statements reflecting its security interest in the appropriate office under North Carolina law. A shipment of trousers were being sent to Brennan in North Carolina from American Samoa via California in October of 1973. *Id.* at 161, 123 Cal. Rptr. at 522. Joint Holdings and Trading Company levied on the trousers while they were in California. *Id.* at 162, 123 Cal. Rptr. at 522. Thus, the conflict is between a lien creditor and a secured party perfected under the laws of North Carolina. The court found in favor of the lien creditor saying that in order to protect itself the bank should have perfected its security interest in "the jurisdiction where the goods are when the interest attaches." *Id.* at 165, 123 Cal. Rptr. at 523. In this case the trousers were in Taiwan when the security interest attached thus the bank should have been perfected under the law of Taiwan. Note that implicit in this holding is the acceptance by the court of the notion that contractual right in property may support a security interest. See also WHITE, UCC, *supra* note 5, at 1050-51.

⁴⁷Ship. *Missouri*, 1989 WL 100, at *18 (1989).

is temporarily transferred from the owner to another"⁴⁸ A bailee does not acquire title to the property but he does possess "a number of rights with respect to the bailed property. Since he is entitled to possession, a bailee 'has a right to protect that possession. . . . So he may bring [an action in] replevin for its possession, or trover for its value when it is so destroyed or injured that the benefits of possession are lessened.'"⁴⁹

Can a bailee of goods transfer a security interest in those goods? Some courts have suggested that he cannot.⁵⁰ Hillman states that it is "wrong to suggest, as some courts have, that no bailee ever acquires rights on which to predicate a security interest in bailed property. . . . [T]he quantum and significance of these rights will vary depending on the facts of each case, and, under the usual rule, no one can convey rights greater than his own."⁵¹ Thus, a bailee may always create a security interest in the bailed goods to the extent of his interest in those goods; however, as a general rule, he may not create a security interest in bailed goods that infringes in any way on the bailor's ownership rights in the goods.

Secured parties are unsatisfied with this result. Many times they are unaware that the interest of the debtor (bailee) in the collateral is limited to a bailee's interest. Therefore, they "have searched the Code for exceptions to the usual rule that a security interest given by a bailee" goes only so far as "the bailee's limited rights in the bailed goods."⁵² Secured parties have pointed to two particular provisions which they believe subordinate the rights of the bailor/owner of goods to their security interest. The two provisions most often used are U.C.C. sections 2-403(1) and (2).

Section 2-403(1) provides in pertinent part that "a person with voidable title has power to transfer a good title to a good faith purchaser for value."⁵³ As discussed above, an article 9 secured party is a good faith purchaser.⁵⁴ If a bailee has voidable title to bailed goods then arguably a secured party's security interest in those goods should be senior to the bailor's ownership interest in the goods by operation of section 2-403(1). Actually, a bailee of goods does not obtain voidable title to those goods.⁵⁵

48. W. ELLIOTT, A TREATISE ON THE LAW OF BAILMENTS AND CARRIERS § 1 (1929).

49. HILLMAN, UCC, *supra* note 5, § 18-19 (citing W. ELLIOTT, *supra* note 48, § 12, at 23).

50. *In re Farmer Grain Exch. Inc.*, 20 U.C.C. Rep. Serv. (Callaghan) 1054 (W.D. Wis. 1976); *Mother Lode Bank v. General Motors Acceptance Corp.*, 46 Cal. App. 3d 807, 120 Cal. Rptr. 429 (1975); *Risch v. Raven Transfer & Storage Co.*, 17 Wash. App. 73, 561 P.2d 1097 (1977).

51. HILLMAN, UCC, *supra* note 5, § 18-19.

52. *Id.* §§ 18-20.

53. U.C.C. § 2-403(1) (1989).

54. See *supra* note 21 and accompanying text.

55. HILLMAN, UCC, *supra* note 5, § 18-25 (citing A. DOBIE, HANDBOOK ON THE LAW OF BAILMENTS AND CARRIERS § 3, at 6 (1914)); 4 S. WILLISTON, A TREATISE
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Therefore, section 2-403(1) does not change the general rule that a bailee of goods cannot convey a security interest in those goods that is senior to the ownership rights of the bailor.

Section 2-403(2) provides that "any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entrustee to a buyer in the ordinary course of business." This section does not help the secured parties. It only allows a merchant (bailee) to transfer good title (i.e., free and clear of the ownership rights of the bailor) to a *buyer in the ordinary course of business*. Secured parties are not buyers in the ordinary course of business.⁵⁶ Therefore, section 2-403(2) does not work to promote the security interest above the ownership rights of bailors.

Secured parties have been unsuccessful in convincing courts that these Article 2 provisions subordinate bailor-owner rights to the security interests of secured parties. There is a common law argument, however, that secured parties may find helpful in accomplishing this result. At least one judge in *In re Sitkin Smelting & Refining, Inc.*⁵⁷ was persuaded that the transaction between the alleged bailor and bailee was not a bailment at all; rather it was a sale. The buyer, then, had the power to grant a security interest to a third party lender which was superior to any interest which the seller might have retained.

The facts of *Sitkin* are important to an understanding of the case. "Prior to its bankruptcy Sitkin Smelting and Refining Company (Sitkin) was in the business of processing industrial waste for the recovery of precious and base metals."⁵⁸ Sitkin entered into an agreement with Eastman Kodak (Kodak) whereby Kodak would provide to Sitkin 500,000 pounds of industrial waste.⁵⁹ Sitkin processed the waste and, according to the majority, was bound to purchase the "silver extract recovered on such processing."⁶⁰ The film waste was to be picked up in lots of 36,000 pounds each by Sitkin.⁶¹ The contract called for a settlement, which was a determination of the amounts owed by Sitkin, after it processed each lot.

C.I.T. Corporation (C.I.T.) claimed a security interest in the inventory of Sitkin.⁶² C.I.T. claimed that the security interest in the inventory of

ON THE LAW OF CONTRACTS § 10-32 (rev. ed. 1936); W. ELLIOTT, A TREATISE ON THE LAW OF BAILMENTS AND CARRIERS § 10 (1929); E. GODDARD, THE LAW OF BAILMENTS AND CARRIERS §§ 7-8 (L. Cullin 2d ed. 1928); J. SCHOULER, THE LAW OF BAILMENTS § 1, at 1 (1905); W. HALE, HANDBOOK ON THE LAW OF BAILMENTS AND CARRIERS § 1-2 (1896).

56. See *supra* note 20 and accompanying text.

57. 639 F.2d 1213 (5th Cir. 1981).

58. *Id.* at 1218.

59. *Id.* at 1214.

60. *Id.*

61. *Id.*

62. *Id.*

Sitkin gave them an interest in the film waste which was senior to the interest of Kodak. The court in *Sitkin* stated that the outcome of the priority dispute between Kodak and C.I.T. turned "upon whether the transaction between the two companies [Sitkin and Kodak] was a bailment or a sale."⁶³ The majority in *Sitkin* held that the transaction between Kodak and Sitkin constituted a bailment rather than a sale.⁶⁴ Thus, the security interest of the secured party, C.I.T., was subordinate to the ownership interest of Kodak.

Judge Clark, in his dissent, disagreed with the majority's characterization of the transaction between Kodak and Sitkin as a bailment.⁶⁵ Judge Clark first found that:

[The] goods to be sold by Kodak to Sitkin were the 500,000 pounds of film waste which contained recoverable silver. There was no sale or purchase of just the silver content in the film waste. The silver content in the film waste, which could only be salvaged on processing, was to serve only as a pricing mechanism for the sale of the 500,000 pounds of film waste.⁶⁶

Judge Clark pointed out that the majority, in classifying the transaction between Sitkin and Kodak as a bailment, relied heavily on two factors: (1) that Kodak had the option to require the film waste be processed or returned; and (2) that the evidence indicated the film waste was being stored by Kodak on Sitkin's behalf.⁶⁷ Judge Clark did not find either of these two factors to be present in this case.

The majority mentioned several aspects of the relationship between Sitkin and Kodak which indicated a bailment rather than a sale.⁶⁸ Judge Clark first noted that the majority found "support for a bailment in Sitkin's agreement to assume responsibility for the waste by picking it up at Kodak's facility in New York and transporting it to warehouses in Alabama that Sitkin had leased."⁶⁹ Judge Clark pointed out that this factor "is just as consistent with a sales transaction as it [is] with a bailment."⁷⁰ The majority also stated that the fact the goods were kept in Kodak cartons in the Sitkin Warehouse indicates a bailment rather than a sale. Judge Clark speculated that the film waste may have been stored this way only because this was the most practical way to store the waste; that is, "[t]here would be no reason for Sitkin to assume the added expense and trouble

63. *Id.* at 1217.

64. *Id.* at 1218.

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.* at 1221.

of removing the film from its cartons and crossing out Kodak's brand name before [Sitkin] began the salvaging process."⁷¹

Judge Clark's dissent in *Sitkin* is authority for the proposition that under the right circumstances a transaction which is outwardly a bailment may be held by a court to be in substance a sale. Thus, a secured party attempting to defeat the claim of an alleged bailor might successfully argue that the bailment is in fact a sale and the security interest in the collateral is, therefore, superior to any interest retained by the seller.⁷² The prospects for this line of attack are certainly much more promising than arguing that a bailment in fact existed but the secured party's rights are nevertheless junior to the rights of the bailor under U.C.C. section 2-403.

C. Corporate Assets as Security for Personal Debts

Corporate officers and employees have, in the past, attempted to use corporate assets to secure personal debts. The question in these cases inevitably becomes "does the party asserting a security interest in the corporate asset really have a security interest in the asset at all?" Two of the requirements of section 9-203 are relevant in answering this question. Section 9-203(1)(a) requires that "the debtor . . . sign[] a security agreement"⁷³ It is important to recognize that the debtor for purposes of section 9-203 is not the obligor. The term debtor, in section 9-203, refers to "the owner of collateral even though he is not the person who owes payment or performance of the obligation secured."⁷⁴ As a second requirement, section 9-203(1)(C) states that "the debtor [must] have rights in the collateral."⁷⁵

Courts may analyze these cases by asking whether the corporate debtor or an agent of the corporate debtor has signed the security agreement. On the other hand, a court might find the critical inquiry to be whether the employee or officer obligor on the note had sufficient rights in the corporate property to convey a security interest in that property to a third party. Regardless of the way the court frames its inquiry, the issue is the same—whether a corporate employee, or officer, who does not own the corporate asset being pledged, has the authority to convey a security interest in the asset to a third party.

For instance, in *In re Terminal Moving & Storage Co., Inc.*⁷⁶ (*Terminal*), Herbert Walker purchased all of the shares of Terminal Moving and Storage

71. *Id.*

72. It should be noted that if the seller retains a purchase money security interest such interest will be senior to all other security interests in the collateral if properly perfected. See *supra* note 32 and accompanying text.

73. U.C.C. § 9-203(1)(a) (1989).

74. Official comment to U.C.C. § 9-112 (1989).

75. U.C.C. § 9-203(1)(c) (1989).

76. 631 F.2d 547 (8th Cir. 1980).

Company (TMS) from Terminal Distribution Centers (TDC).⁷⁷ Walker paid for the shares by giving TDC \$10,000 in cash and a \$90,000 note.⁷⁸ "On the same day [TMS] under the authority of the new president and sole shareholder, Walker, executed a security agreement in favor of [TDC] pledging all of the assets of [TMS] to secure the [\$90,000] promissory note of Walker."⁷⁹ TDC properly perfected its security interest.⁸⁰

About four years later TMS "filed a chapter XI plan for corporate reorganization."⁸¹ The trustee in bankruptcy asserted that the security agreement of TMS in favor of TDC was ultra vires under Arkansas law and was therefore void and of no effect.⁸² The court rejected this argument and held that the trustee lacked standing to assert an ultra vires defense.⁸³ The court further stated that "the assent of all the shareholders [i.e., Walker] to the security agreement bars any claim in the right of the corporation to defeat it."⁸⁴

Compare *Terminal* with the case of *Northwestern Bank v. First Virginia Bank of Damascus*.⁸⁵ *Northwestern Bank* presents facts very similar to those found in *Terminal*, however, the decision of the court in *Northwestern Bank* is different than the decision in *Terminal*.

In *Northwestern Bank*, Mr. Shepherd and Mr. McElwee formed a corporation called Ray Shepherd Lumber Company (Company).⁸⁶ Shepherd served as president of the Company.⁸⁷ On October 20, 1978, the Company purchased a Caterpillar 920 Wheel Loader (Loader) using funds loaned by Northwest Bank.⁸⁸ Northwest Bank acquired a security interest and filed in North Carolina, the location of the loader.⁸⁹ In February or March of 1982 the loader was moved into Virginia.⁹⁰ In March of 1982 Shepherd and two others applied for a personal loan at the First Virginia Bank of Damascus (Virginia Bank).⁹¹ Since this was a personal loan, the Company was in no way obligated on the note. Shepherd caused Virginia Bank to believe he owned the loader and would be willing to convey a security

77. *Id.* at 549.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.* at 550.

84. *Id.* See also *Widett v. Pilgrims Trust Co.*, 143 N.E.2d 167 (Mass. 1958).

"The assent of all the stockholders to the giving of a mortgage [by the corporation] bars any claim, in the right of the corporation to defeat it. . . ." *Id.* at 170.

85. 585 F. Supp. 425 (W.D. Va. 1984).

86. *Id.* at 426.

87. *Id.*

88. *Id.*

89. *Id.* at 426-27.

90. *Id.* at 427.

91. *Id.*

interest in the loader to secure the note.⁹² Virginia Bank determined that Mr. Shepherd did own the loader and approved a loan for \$25,000, taking a security interest in the loader.⁹³ The security interest was perfected by filing a financing statement according to Virginia law.⁹⁴

The Company defaulted on its note payable to Northwest Bank. Shepherd defaulted on the note payable to Virginia Bank.⁹⁵ The conflict then was between Northwest Bank and Virginia Bank to determine which bank had the senior claim to the loader. The court found in favor of Northwest Bank stating that Virginia Bank did not have a valid security interest in the loader.⁹⁶

The court gave two reasons for its decision. First, the court noted that in order to have a valid security interest the debtor must sign the security agreement. When the obligor on the note and the owner of collateral are not the same person, the owner of the collateral must sign the security agreement.⁹⁷ In this case, the Company owned the asset and no one representing the Company signed the security agreement.⁹⁸ Therefore, the security interest of Virginia Bank never attached to the loader because of a failure to comply with U.C.C. section 9-203(1)(a).⁹⁹

The court also stated that Virginia Bank's security interest failed for another reason: "Generally a debtor must have rights in property before he can create a security interest in it"¹⁰⁰ The company, rather than the debtor, Mr. Shepherd, was the owner of the property. The court did state that a "debtor possesses 'rights in the collateral' if the true owner agrees to the debtor's use of property as security or if the true owner is estopped to deny the creation or existence of the security interest."¹⁰¹ Neither consent nor estoppel was present in this case.¹⁰² Therefore Virginia Bank's security interest never attached because Mr. Shepherd did not have rights in the loader.

The cases discussed above indicate that courts will probably make a two step inquiry into transactions involving a pledge of corporate assets to secure personal employee, officer, or shareholder debts: 1) has the proper party signed the security agreement, and 2) does the debtor have rights in the collateral as pointed out by the *Northwestern Bank* court. Nevertheless, all is not lost for a secured party even if the corporation did not sign the

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* at 428.

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.* at 429.

102. *Id.*

security agreement. A secured party may be able to argue either that the corporation consented to the use of its property as collateral or that the corporation should be estopped from denying that the obligor is the true owner of the property.¹⁰³ If the secured party is able to convince the court that the corporation has signed the security agreement, consented to the use of its property as security for a debt, or is estopped from denying that a valid security agreement exists, then the secured party's security agreement should stand.¹⁰⁴

Estoppel can be used by secured parties against people asserting that the security interest is invalid. The word estoppel "means simply that someone is stopped from claiming or saying something; usually he is stopped from claiming a lawful claim and usually this is because of some prior inconsistent statement or activity."¹⁰⁵ The concept of estoppel is illustrated by the case of *In re Matter of Pubs Inc. of Champaign*.¹⁰⁶ In *Pubs*, two officers (Officers) of a corporation (Corporation) granted a security interest to the Bank of Illinois (Bank) in certain equipment (Equipment) which they owned.¹⁰⁷ The court found that "it was the intention of both [the Officers] Hein and Richardson to borrow the money personally from the Bank, grant a security interest in the Equipment to the Bank and then transfer the Equipment to the Corporation" subject to the Bank's security interest.¹⁰⁸ On November 5, 1976, Hein executed a security agreement granting the Bank a security interest in the Equipment.¹⁰⁹ Richardson did not sign the security agreement until November 16, 1976.¹¹⁰ The Bank deleted the November 5 date from the security agreement and substituted November 16, 1976.¹¹¹ The security interest was granted to the Bank as of record on November 16, 1976. Hein and Richardson "executed a bill of sale and a conveyance of the [Equipment] to the [Corporation]" on

103. See *infra* note 107.

104. Some courts might make a third inquiry. Did the funds borrowed go to the benefit of the corporation? If they did not, then the security interest might be held invalid. See *In re Just for the Fun of It of Tennessee, Inc.*, 7 Bankr. 166 (E.D. Tenn. 1980). This case deals with the analogous situation of the validity of a real estate mortgage on corporate property to secure a non-corporate personal obligation of an officer of the corporation.

105. D. DOBBS, REMEDIES—DAMAGES, EQUITY, RESTITUTION (1973). See also *Avco Delta Corp. Canada Ltd. v. United States*, 459 F.2d 436 (7th Cir. 1972). "Whatever title the defendant has must rest on the doctrine of estoppel. This is an equitable doctrine taken over by the law. It is based upon the conduct of the true owner, whereby he has allowed another to appear as the owner, or as having full power of disposition over the property, so that an innocent person is led into dealing with such apparent owner." *Id.* at 440-41.

106. 618 F.2d 432 (7th Cir. 1980).

107. *Id.* at 435.

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.*

November 9, 1976.¹¹² The bill of sale stated that the equipment was being conveyed to the Corporation subject to the Bank's security interest.¹¹³ Nevertheless, the Corporation argued that at the time the security interest in the equipment was conveyed to the Bank, (November 16, 1976), the Officers no longer had any rights in the Equipment because of the transfer to the Corporation on November 9, 1976. The court rejected this argument. The court noted that "one may be estopped from asserting his rights if his words or conduct have led another party to take some action which he would not otherwise have taken but for the words or conduct of the estopped party."¹¹⁴ The Corporation was estopped because it knew the Bank thought the corporation was receiving a valid security interest in the Equipment but failed to tell the Bank otherwise. This prevented the Bank from protecting itself by not disbursing the loan proceeds. The court held:

[T]he corporation is estopped to deny the validity of the bank's security interest. [The Corporation's] title to the property was clearly evidenced by the November 9, 1976, bill of sale which recited that [the Corporation] took the collateral subject to the Bank's security interest. Having been put on notice by the recital of the bill of sale [the Corporation] is estopped to deny the recited security interest by claiming an interest superior to it.¹¹⁵

It is also possible that a court could find that a debtor has rights in collateral as a result of the true owner consenting to the debtor's use of the property as collateral. For instance, in the *Pubs* case the court could have based its holding on a finding that the corporation consented to the officers' use of the equipment as collateral. Consent is similar to the concept of estoppel. The difference between consent and estoppel is that to find consent a court must examine the true owner's conduct toward the debtor whereas, with estoppel, the court focuses on the true owner's conduct toward the secured party.

D. Debtor's Interest as Joint Owner of Property

There are essentially three ways that a debtor might jointly own a piece of property with another: tenancy in common, joint tenancy, and tenancy by the entirety.¹¹⁶ A debtor can clearly mortgage his interest in property which he owns as a tenant in common¹¹⁷ or a joint tenant.¹¹⁸ Jurisdictions disagree on whether one spouse can unilaterally transfer his

112. *Id.*

113. *Id.*

114. *Id.* at 438.

115. *Id.*

116. See generally R. CUNNINGHAM, W. STOEBUCK AND D. WHITMAN, *THE LAW OF PROPERTY* § 5.1 (1984) [hereinafter *THE LAW OF PROPERTY*].

117. See *Z.V. Pate, Inc. v. Kollock*, 202 S.C. 522, 25 S.E.2d 728 (1943).

118. See generally *THE LAW OF PROPERTY*, *supra* note 116, § 5.4.

interest in property which he holds as a tenant by the entirety.¹¹⁹ Tenants by the entirety, only husbands and wives, hold under a single title with rights of survivorship."¹²⁰

Conflicts commonly arise between a nondebtor tenant by the entirety and a creditor of the debtor spouse. The debtor spouse will have given the creditor a security interest in the property without the consent of the nondebtor spouse. The question becomes what rights, if any, does the creditor have by reason of such conveyance? Courts have answered this question in three different ways. Some courts have held that a spouse acting alone is powerless to convey any interest in tenancy by the entirety property.¹²¹ Other jurisdictions have held that a secured party's security interest may attach to tenancy by the entirety property without the consent of both spouses. But these states have also held that if the secured party did have to foreclose and sell the debtor's interest in the property "a purchaser at [such a sale would] succeed to the estate only in the event that the debtor outlived the other tenant by the entirety."¹²² Massachusetts takes a unique position to this problem by statutorily barring a creditor from reaching the interest of the debtor spouse if the property is the principal residence of the nondebtor spouse. Any other property is available to satisfy the debts of the debtor spouse.¹²³

CONCLUSION

The question of who has priority in disputes over property used as collateral is often answered by determining what interest the debtor has in the property. Oftentimes, a secured party will take a security interest in property only to find out at the crucial time—when the debtor has defaulted on the loan—that a security interest does not exist because the debtor did not have a sufficient interest in the property. To protect his interests, a secured party should investigate the interest the debtor is claiming in the property he is offering for collateral. The secured party should then determine what his rights in the collateral would be should the debtor

119. See *infra* notes 120-22 and accompanying text.

120. *In re Grosslight*, 757 F.2d 773, 775 (6th Cir. 1985).

121. Missouri courts have held that one spouse acting alone cannot convey any interest in tenancy by the entirety property. *In re Newcomb*, 744 F.2d 621 (8th Cir. 1984); *Merrill, Lynch, Pierce, Fenner & Smith v. Shackelford, Inc.*, 591 S.W.2d 210 (Mo. Ct. App. 1979).

Michigan courts have also adopted the Missouri position. See *In re Grosslight*, 757 F.2d 773 (6th Cir. 1985).

122. *In re Walls*, 45 Bankr. 145, 146 (Bankr. E.D. Tenn. 1984); *In re Young*, 42 Bankr. 892 (Bankr. E.D. Tenn. 1984); *In re Stephenson*, 19 Bankr. 185 (M.D. Tenn. 1982); *In re Tsunis*, 29 Bankr. 527 (Bankr. E.D. N.Y. 1983); *Napotnich v. Equibank & Parkvale Sav. Ass'n*, 679 F.2d 316 (3d Cir. 1982).

123. MASS. GEN. L. ch. 209, § 1 (1980).

default. Without the requisite ownership interest by the debtor, the secured party is not a secured party at all.

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